HOUSE BUDGET COMMITTEE

Democratic Caucus

The Honorable John M. Spratt Jr. ■ Ranking Democratic Member

B-71 Cannon HOB ■ Washington, DC 20515 ■ 202-226-7200 ■ www.house.gov/budget_democrats

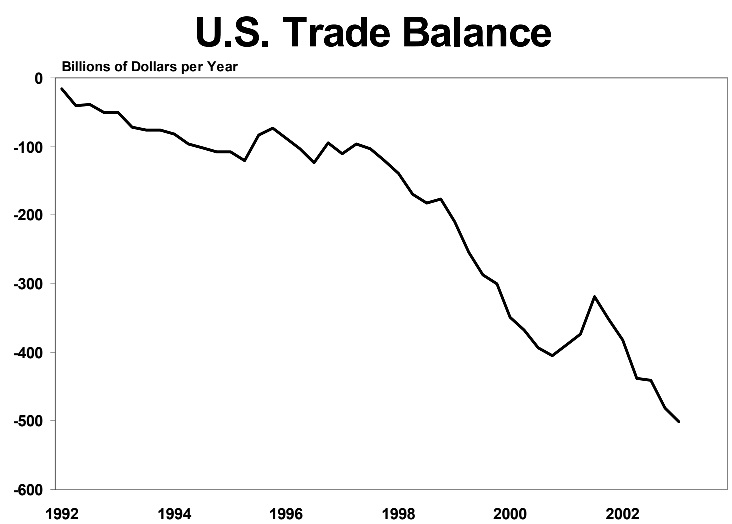
May 14, 2003

Trade and Budget Data Confirm Twin Deficits Continue to Grow

Dear Democratic Colleague:

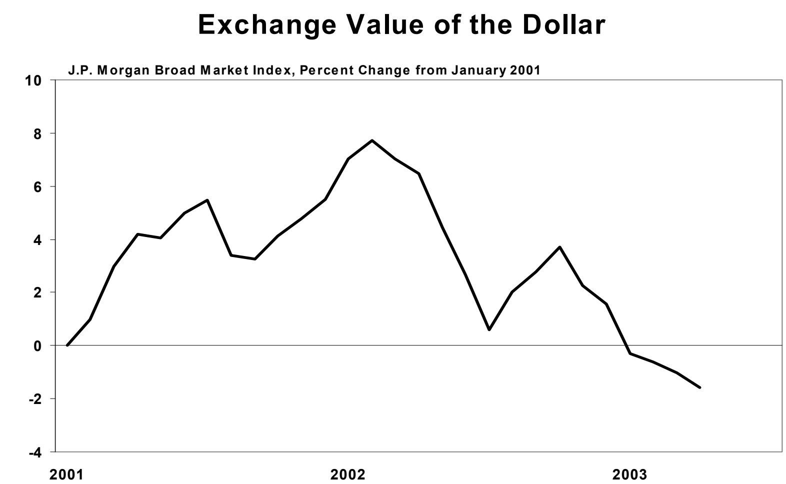
Yesterday, the Commerce Department reported that the United States posted a record trade deficit in the first quarter of 2003, equivalent to an annual shortfall of more than $500 billion. And last Friday, the Congressional Budget Office (CBO) reported that the budget deficit this year also will post a record, exceeding $300 billion even without the new tax cuts Republicans advocate. Either of these trends would be sufficiently worrisome by itself. Together, they increase the risk that a loss of confidence in U.S. financial obligations may permanently weaken our position in the world economy.

Historically, international capital has avoided nations that attempted simultaneously to run large budget deficits and large trade deficits. This stems from international investors' fear that countries in this situation have increasing difficulty achieving sufficient economic growth to service both their domestic and foreign debts. Furthermore, once capital starts to be withdrawn from a country and its currency declines, investors have additional reason to withdraw their money because the falling exchange rate further reduces the value of their investments. In the worst case, capital can abruptly flee nations that appear in danger of succumbing to a vicious circle. In this instance, international capital comes to believe that interest on debt has become a major contributor to the growth of debt and that currency declines will further reduce the value of foreigners' investments.



When a country has both large trade and budget deficits, the economy must (1) generate sufficient taxes for servicing the public debt, (2) produce sufficient dividends, interest, and rent to pay foreign creditors for their investments, and (3) still have enough left over to sustain the domestic population's living standards. This means that domestic workers and businesses must produce quite a bit more than they themselves receive as income. The larger this divergence between what a country must produce and what it receives as income, the more likely that international creditors will see the condition as unsustainable. (For a further elaboration of the twin deficits' burden on future workers, see http://www.house.gov/budget_democrats/analyses/twin_deficits_april03.pdf.)

International investors still have faith in their U.S. investments. But the weakening of the dollar in the last 19 months suggests that that may be changing. Since its peak in February 2002, the exchange value of the dollar has fallen 8.6 percent, with the dollar falling to a four-year low against the euro, suggesting that some capital may be seeking safer havens.

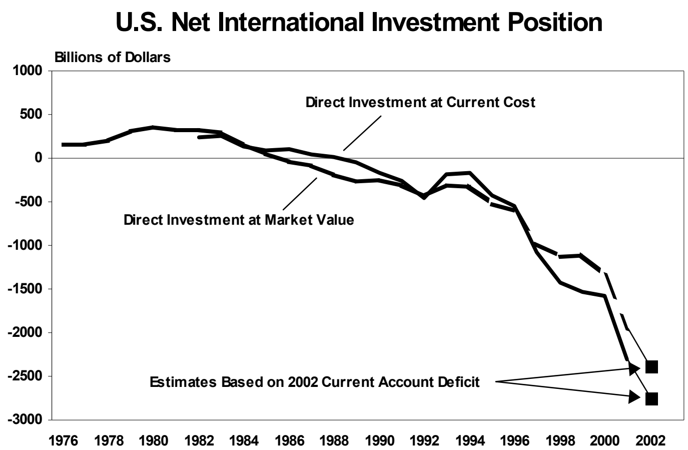


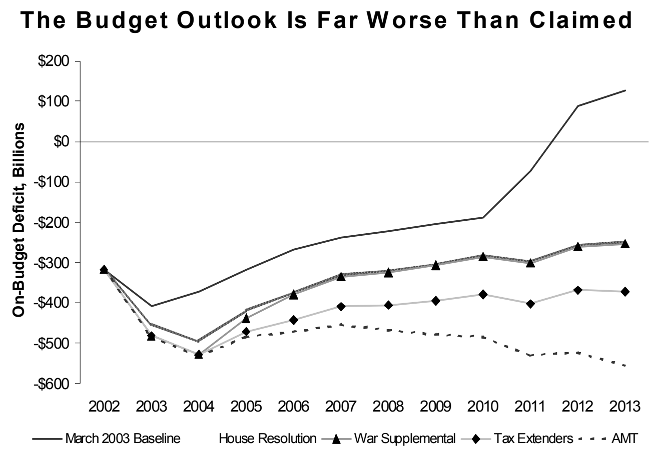
Certainly, the dollar's fall reflects the Federal Reserve's stimulative monetary policy and low interest rates to some extent. However, outside commentators also have begun to argue that the United States is veering into dangerous financial territory. Most notably, Kenneth Rogoff, Chief Economist of the International Monetary Fund (IMF), which typically assists countries that suffer capital flight, noted on April 10:

> Suppose for a moment we were talking about a developing country that had a gaping [trade] deficit year after year as far as the eye can see, budget ink spinning from black into red, open-ended security costs, and an exchange rate that has been inflated by capital inflows. With all that I think it's fair to say we'd be pretty concerned.

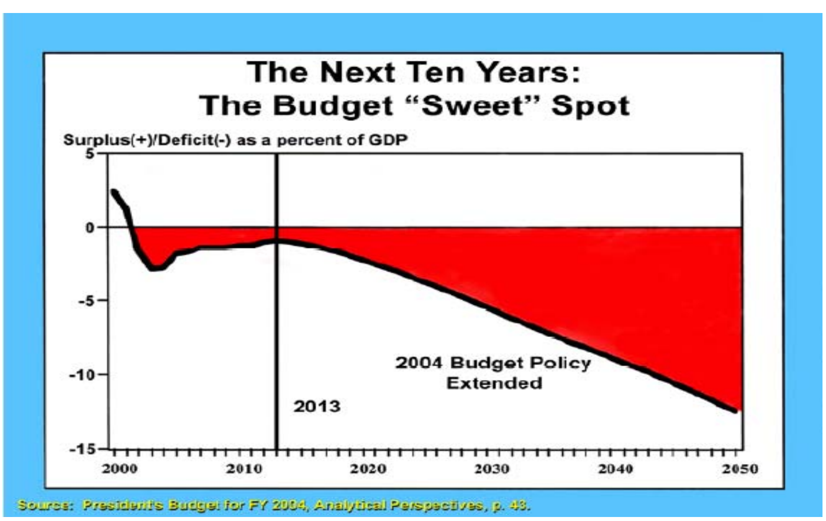
Typically, such doubts begin when a country's budget and trade deficits approach five percent of GDP. This is the territory into which the U.S. economy currently is heading. The trade deficit this year will be about 5 percent of GDP unless it turns around sharply in coming months, which appears most unlikely. In addition, the budget deficit for this year will be about 4 percent of GDP, once one factors in the impact of a new tax cut and more supplemental appropriations to pay for peacekeeping in Iraq and natural disasters. And, most private-sector analysts believe next year's budget deficit will be even worse.

These flows of new indebtedness come on top of huge existing financial commitments. The U.S. already has gone from being the world's largest creditor nation to the largest debtor, with about $2.5 trillion in financial commitments to foreign creditors. At the same time, publicly held government debt already totals close to $4 trillion, and it too is going up. Even the Administration's projection shows the 2004 budget deficit exceeding this year's, and the many unacknowledged costs in the President's budget imply that this projection is optimistic. (For a delineation of budget costs omitted from the President's budget, see http://www.house.gov/budget_democrats/congressional_budgets/fy2004/conference.pdf.)





On top of this, one must add the single largest fiscal burden facing the United States: the imminent retirement of the Baby Boom generation. This begins in just five short years when those born in 1946 first become eligible for reduced Social Security benefits in 2008. The real brunt of this fiscal tidal wave hits, though, beyond the usual ten-year budget estimating window. Increasing numbers of Baby Boom retirees, combined with escalating health care costs will put immense pressures on the budget deficit. This is dramatically illustrated by a long-range chart from the President's budget this year, shown below.



Unless these adverse trends are reversed, there is a risk that international investors will no longer confidently invest in the United States. Thus far, this has not happened. But we may be entering the danger zone.

Sincerely,
/s/
John M. Spratt, Jr.
Ranking Member